Please note that the commentary is for the retail class of the Fund.

In a negative quarter for financials, the Fund returned -16.7%, bringing the one-year return to 14.4%. The long-term performance of the Fund remains pleasing at 10.6% annualised and alpha of 1.3% since inception.

As the Russian invasion of Ukraine continues, worsening geopolitical tensions have increased the risk of higher global inflation and a faster normalisation in global monetary policy. June saw some developed market central banks tightening monetary policy to curb rising inflation after some upside surprises to inflation data during the quarter. While US data is expected to have peaked, inflation in the euro area and the UK is expected to accelerate further as price pressures associated with the impact of the war in Ukraine continue to be felt. In the US, the Federal Reserve Board raised the target range of the federal funds rate by 75 basis points (bps) moving the range to 1.50% to 1.75%. In the UK, the Bank of England (BOE) raised its policy rate by 25bps to 1.25% at the June Monetary Policy Committee (MPC) meeting. While the European Central Bank (ECB) left policy rates unchanged at the June MPC meeting, the ECB signalled it will raise its policy rates in July and September by implementing a 25bps rate hike at each meeting. The South African Reserve Bank (SARB) is due to meet in July and the expectation is for a 50bps rate hike, taking the repo rate to 5.25%. SA has benefited from a significant terms of trade boost that provides more breathing room for the fiscus, but supply side constraints and high energy prices will place pressure on the SARB to normalise rates at a pace consistent with that of major global central banks.

Against this backdrop, equity markets came under pressure during the quarter. The MSCI World Index declined 16.2%, while the MSCI Emerging Markets Index fell 11.4% in US dollars in the quarter. SA was not spared, with the All Share Index declining 20.8% (in USD) after the rand weakened 10.3% against the US dollar. Within the SA market, basic materials was the weakest sector, declining 21.6% in rands, followed by financials (-15.8%), with industrials outperforming at -4.5%. Within the financial sector, banks (-14.5%) outperformed life insurers (-23.1%).

In a rising interest rate environment, banks will benefit from the widening of interest margins as they earn more on their interest free ‘lazy’ deposits and capital (endowment benefit). Higher rates also drive deterioration in credit quality as customers struggle to make payments and economic activity slows. The SA banks come into the current rate hiking cycle with strong capital ratios and good provision coverage to mitigate against any deterioration in credit quality as rates rise. The sharp fall in bank shares in the last quarter presents an opportunity. At current levels, Absa, Standard Bank and Nedbank trade between 5 and 6 times price-earnings multiples two years out, 8% to 9% dividend yields one year out and between 1 and 1.3 times price-to-book multiples. While FirstRand trades at a meaningful premium to the other three banks, we believe this premium is justified given their higher return on equity.

The sharp fall in equity markets has a significant near-term earnings impact on asset management and wealth businesses that earn revenues as a percentage of their assets under management. However, the long-term franchise value of these businesses remains unchanged, particularly if one takes that markets will ultimately recover over the long term. Some of these businesses continue to grow their assets under management by taking in fund inflows which offsets some of the near-term challenges from the market decline. The Fund has holdings in Quilter, a UK wealth manager, and Ninety One, an asset management company. Shares in these companies have come under some pressure because of the decline in equity markets and now present even more attractive investment opportunities. Quilter has a significant adviser base that positions them strongly in the UK savings market where consumers enjoy more control over their savings. Ninety One has invested in its distribution presence across many markets outside of SA and with the costs now in place, will look to leverage their scale and grow assets. Current share prices do not adequately reflect the opportunities in both businesses.

Contributors to performance for Q2-22 include overweight positions in RMI Holdings, Nedbank, PSG Group, Standard Bank and Santam. Detractors from performance included underweight positions in Investec Bank and HCI, as well as overweight positions in Transaction Capital, Discovery and Quilter. Significant actions in the Fund during the quarter included increasing the banks as valuations became more attractive by adding to Absa, Standard Bank, Nedbank and FirstRand. We also added to holdings in Transaction Capital and Quilter. We funded these from Investec Bank, Momentum Metropolitan Holdings and PSG Group.

The sharp fall in equity markets globally presents opportunities for stock pickers to acquire great franchises at attractive valuations. This opportunity extends into the SA financials universe. We continue to position the Fund to benefit from these opportunities.

Portfolio managers
Neill Young and Godwill Chahwahwa
as at 30 June 2022